DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 99-0552
Income Tax
For Tax Year 1995

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ISSUES

I. Adjusted Gross Income Tax—Unitary (Combined) Filing Status

Authority: *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 180, n. 19, 103 S.Ct. 2933, 2948, n. 19 (1983)
IC 6-2.1-5-5(b); IC 6-3-2-2(l); IC 6-3-2-2(q)
35 ILCS 5/1501(a)(27); Tenn.Code Ann. § 67-4-2004(25)(B)

Taxpayer protests Tax Policy's 1996 decision denying taxpayer permission to file unitary combined tax returns, and requests that we revisit Tax Policy's 1996 decision.

II. Adjusted Gross Income Tax—Consolidated Returns

Authority: *Indiana Department of State Revenue v. Continental Steel Corp.*, 399 N.E.2d 754 (Ind.App. 1980); *Gilmore Steel Corporation v. Indiana Department of State Revenue*, 9 OTR 210; *Chattanooga Glass Co. v. Strickland*, 244 Ga. 603, 261 S.E.2d 599 (1979); *Miles Laboratories v. Department of Revenue*, 274 Ore. 395, 546 P.2d 1081 (1976)
IC 6-3-2-2; IC 6-3-2-2(a)(2); IC 6-3-2-2(a)(5); IC 6-3-4-14
45 IAC 3.1-1-38; 45 IAC 3.1-1-111
15 USC §§ 381-384 (1999) (P.L. 86-272)

Taxpayer claims that if taxpayer and its four affiliated members do not qualify to file on a unitary basis with taxpayer for Indiana tax purposes, then alternatively taxpayer and the four members do qualify to file on a consolidated basis. As such, taxpayer protests the Audit Division's determination that four members of taxpayer's affiliated group should have been removed from taxpayer's consolidated adjusted gross income tax return because they did not have adjusted gross income from sources within Indiana.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation and holding company and parent of numerous wholly owned subsidiaries. Taxpayer operates under its parent corporation, a European based multi-national corporation (hereinafter, "Parent"). Taxpayer is responsible for securing financing for all United States based subsidiary corporations. Taxpayer is also responsible for providing its Parent with consolidated financial information, as well as other financial information regarding the United States based operations. In December 1995, taxpayer requested permission from the Tax Policy division of the Department of Revenue to file unitary combined tax returns with its subsidiaries, effective for the tax year 1995. In a letter dated February 1996, Tax Policy denied taxpayer permission to file on a unitary basis.

For its tax year 1995, taxpayer filed a consolidated Indiana return (Form IT-20) with its subsidiaries, *i.e.*, the members of its affiliated group, for gross income and adjusted gross income tax purposes. A tax assessment resulted when the auditor excluded four subsidiaries from the taxpayer's Indiana consolidated return for income tax purposes because the subsidiaries where neither incorporated in nor qualified to do business in Indiana. The auditor then added to taxpayer's taxable gross income the inter-company receipts that were deducted under the consolidated return. The auditor also disallowed the taxpayer's consolidated filing for adjusted gross income tax purposes, with respect to the four subsidiaries, because the subsidiaries did not have sufficient nexus with Indiana to qualify for consolidated filing status. Specifically, the auditor noted that she excluded the subsidiaries on the basis that the subsidiaries did not have adjusted gross income derived from Indiana sources. Additional facts appear below as necessary.

I. Adjusted Gross Income Tax—Unitary (Combined) Filing Status

DISCUSSION

Taxpayer concedes that it overlooked Indiana's requirement that members of an affiliated group be incorporated in the state of Indiana or authorized to do business in the state of Indiana to file a consolidated return for gross income tax purposes. *See* IC 6-2.1-5-5(b). Nevertheless, taxpayer asks the Department to revisit Tax Policy's determination that taxpayer may not file unitary combined returns.

In addressing the question of whether Tax Policy erred in denying taxpayer permission to file on a unitary basis, we first examine whether a unitary relationship actually exists between taxpayer and its subsidiaries. If we find that a unitary relationship exists, we then determine whether

filing a combined return would more fairly represent the taxpayer's and subsidiaries' Indiana income.

The Supreme Court over the years has developed a three-part test in determining whether a unitary relationship exists: common ownership, common management, and common use or operation. *See*, *e.g.*, *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992). The first item to be considered under this three-part test is common ownership. As a general rule, at least fifty percent (50%) of a corporation's stock must be commonly owned (either directly or indirectly) in order for a corporation to be considered part of a unitary business. *See*, *i.e.*, 35 ILCS 5/1501(a)(27) and Tenn.Code Ann. § 67-4-2004(25)(B). The information in taxpayer's file shows that during the audit period, taxpayer owned one hundred percent (100%) of the stock of the members of the affiliated group. The evidence of file is sufficient to establish common ownership.

The second criteria to be considered is common management. Common management is shown when the parent corporation provides a management role that is grounded in the parent's own operation expertise and overall operational strategy. *See*, *e.g.*, *Container Corp. V. Franchise Tax Board*, 463 U.S. 159, 180, n. 19, 103 S.Ct. 2933, 2948, n. 19 (1983).

Here, the taxpayer has supplied evidence which shows that taxpayer exercised control and influence over its subsidiaries. Taxpayer's upper management consisted of five officers, the Chairman, the Deputy Chairman, the President/Chief Executive Officer, and the Secretary/Treasurer/Chief Financial Officer. Each one of taxpayer's subsidiaries was headed by a Chief Executive Officer. Taxpayer's executive officers were in constant communication with the Presidents of the subsidiaries, the executive officers provided executive decision-making for the subsidiaries. Taxpayer's executive officers, though they maintained offices in Indiana, made most of the executive decisions for the subsidiaries. Specifically, the officers reviewed and approved requests for capital expenditures and customer credit limits; frequently participated in monthly operational meetings; reviewed monthly financial statements; assisted in the preparation, review, and approval of annual operating budgets; and, negotiated and entered into legal contracts on behalf of the subsidiaries. We find that common management existed between taxpayer and its subsidiaries.

The third test is that of common operation or use. Evidence of a common operation exists where certain functions are performed for the group by the parent (such as purchasing, financing, advertising, marketing, research, tax compliance, insurance, and pension plan management) which independent companies would perform for themselves.

In taxpayer's case, information was supplied which shows that many of the administrative, management, and financing functions for taxpayer's subsidiaries were centralized. Taxpayer's Treasurer/Chief Financial Officer (CFO) coordinated all banking matters for the subsidiaries, and maintained a centralized banking system whereby each subsidiary's bank balance was swept

nightly into taxpayer's main "sweep" account. Taxpayer's CFO was also responsible for obtaining loans to finance the subsidiaries' working capital and capital expenditure needs, and investing cash for the subsidiaries. Taxpayer provided administrative and management assistance to the subsidiaries with their respective insurance and benefit plans. Taxpayer's CFO coordinated the writing of all insurance policies protecting the operations and assets of all of the subsidiaries. These policies included worker's compensation insurance; general, auto and product liability, property and casualty coverage; and, business interruption coverage. Taxpayer's human resources manager obtained health, dental, life and disability insurance coverage for all subsidiary employees. Taxpayer also served as plan sponsor and plan administrator of a profit sharing and 401(k) plan and trust in which employees of the subsidiaries were eligible to participate. Taxpayer's tax manager handled all of the corporate income tax and franchise tax matters for all of the subsidiaries, including making tax payments, filing returns, and coordinating tax audits.

Furthermore, taxpayer provided documentation that shows that one of the subsidiaries provided assistance to two other subsidiaries in establishing credit for customers and evaluating customers' credit-worthiness. However, if a customer of a subsidiary required credit exceeding one hundred thousand dollars ($100,000), credit approval had to come from an officer of taxpayer.

Based on the forgoing, the Department finds that taxpayer has sufficiently established that a unitary relationship existed between taxpayer and its subsidiaries for the 1995 tax year. There exists the elements of common ownership and common management; and, there exists a flow of value between the members of the affiliated group.

We now turn to the next point of analysis and the question of whether requiring taxpayer to use a standard apportionment filing method, instead of combined return filing, resulted in a distortion of the income taxpayer and its subsidiaries reported as Indiana source income. Although IC 6-3-2-2(q) allows a parent corporation to petition the Department to file a combined return, it also incorporates by reference the restrictions imposed on alternative methods of reporting adjusted gross income by subsection (l) of that same section. Subsection (l) states in pertinent part:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> . . .
>
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is clear from the language in subsection (l) that the standard apportionment filing method is a preferred method of representing a taxpayer's income derived from Indiana sources. Other methods of income allocation and apportionment (including the combined reporting method) should only be allowed when those provided for by IC 6-3-2-2 do not fairly reflect a taxpayer's Indiana income. As stated in a more concise manner, if the Indiana source income in the instant

case can be fairly represented on the basis of standard apportionment or separate accounting, then such filing methods should be used.

Despite the unitary relationship between taxpayer and its subsidiaries, it does not appear that the operations of the businesses were so integrated to the point where the filing of separate returns would lead to a distortion of income. From the evidence of file, it appears that each business operation in the affiliated group operated independently of the others. Taxpayer and each of the subsidiaries had their own employees that performed the work assigned to the particular business facility. Each business operation in the affiliated group received orders and completed the production cycle of raw material to finished product within its respective facility. Although some of the subsidiaries shared common officers who provided executive decision-making, there was no flow of product between taxpayer and the subsidiaries. Moreover, taxpayer assessed an "inter-company finance charge" to each subsidiary. The finance charge was intended to cover the cost of the services taxpayer provided to the subsidiaries on a "cost pass-through" basis.

The documentation presented by taxpayer does not convince us that the business operations of taxpayer and the subsidiaries was so interconnected that it becomes impossible to accurately determine the Indiana source income attributable to the respective subsidiaries.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax—Consolidated Returns

DISCUSSION

Taxpayer next protests the Audit Division's determination that four members of taxpayer's affiliated group should have been excluded from taxpayer's consolidated adjusted gross income tax return because the four members did not have adjusted gross income from sources within Indiana. In reaching its determination, the auditor found specifically that: "[N]one of the companies [has] property (land, buildings, other equipment, rental property) or inventory located in Indiana. Also, none of the companies [has] any employees located in Indiana (no Indiana payroll)." *Explanation of Adjustments*, Page 4.

Taxpayer maintains that two of the four excluded members of the affiliated group derived adjusted gross income from sources within Indiana and should be allowed to file consolidated tax returns with taxpayer. The gravamen of taxpayer's argument is two-fold. Taxpayer maintains that the two affiliated members had sufficient nexus with the state of Indiana because (1) they were doing business in Indiana; and (2) they had intangibles attributable to Indiana in that their respective company funds were swept daily into a concentration account maintained at an Indiana bank. *See* IC 6-3-2-2(a)(2) and IC 6-3-2-2(a)(5).

An affiliated group of corporations may file a consolidated return provided that each member corporation has adjusted gross income derived from sources within the state of Indiana and that each member corporation consents to all provisions of the consolidated return regulations defined under Internal Revenue Code Section 1502. IC 6-3-4-14. The term "adjusted gross income derived from sources within the state of Indiana" is defined under IC 6-3-2-2, in relevant part, as follows:

> Sec. 2. (a) With regard to corporations and nonresident persons, 'adjusted gross income derived from sources within Indiana', for the purposes of this article, shall mean and include:
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> (1) income from real or tangible personal property located in this state;
>
> (2) income from doing business in this state;
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> . . .
>
> (4) compensation for labor or services rendered within this state; and
>
> (5) income from stocks, bond, notes, bank deposits, [etc.] . . . other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

45 IAC 3.1-1-38 defines the phrase "doing business" as follows:

> For apportionment purposes, a taxpayer is 'doing business' in a state if it operates a business enterprise or activity in such state including but not limited to:
>
> (1) Maintenance of an office or other place of business in the state
>
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
>
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
>
> (4) Rendering services to customers in the state
>
> (5) ownership, rental or operation of a business or of property (real or personal) in the state
>
> (6) Acceptance of orders in the state
>
> (7) Any other act in the state that exceeds mere solicitation or orders that is exempted from income taxation by P.L. 86-272 to tax its net income.
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> . . . [C]orporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n).

The above language is not ambiguous. It provides that an affiliated group may file an Indiana consolidated return if it meets the requirements of IC 6-3-4-14(b) (*i.e.*, that the affiliated group meet the Internal Revenue Code's definition of an affiliated group found in Section 1504, and further, that the group may include only those member corporations which have Indiana adjusted gross income). 45 IAC 3.1-1-111 also adopts this view, and further clarifies that Indiana adjusted gross income "means either income or losses derived from activities within the state."

PENNSYLVANIA SUBSIDIARY

The evidence before us establishes that one of the subsidiaries was a Pennsylvania corporation with manufacturing facilities and offices located in Pennsylvania (the "Pennsylvania Subsidiary"). Pennsylvania Subsidiary manufactured vinyl framed mobile home windows. During the audit year, both subsidiaries in question shared common executive officers. As was stated above, these officers maintained offices in Indiana and made most of the executive decisions for the subsidiaries, such as: reviewed and approved requests for capital expenditures, reviewed and approved customer credit limits, participated in monthly operational review meetings, reviewed monthly financial statements, assisted in the preparation, review and approval of annual operating budgets, and negotiated and entered into various legal contracts on behalf of the subsidiaries.

The evidence of file further establishes that approximately twenty-one percent (21%) of Pennsylvania Subsidiary's total sales were to Indiana customers in the form of made-to-order product that was sold and shipped to an Indiana based member of the affiliated group. The product was warehoused at the business site of the Indiana based affiliate until such time as the Indiana based affiliate sold the product to its customers. Additionally, according to taxpayer, Pennsylvania Subsidiary employees (or a representative of Pennsylvania Subsidiary that was actually employed by another member of taxpayer's affiliated group) at times traveled to Indiana to perform quality checks and provide technical assistance on the product that was sold to the Indiana customers.

Finally, Pennsylvania Subsidiary maintained a policy by which at the end of each business day, Pennsylvania Subsidiary swept its bank balance into a centralized concentration account that was maintained by the affiliated group and held by an Indiana bank. The concentration account earned interest income.

Given the facts of the instant case, neither the activities of the executive officers nor the interest income earned from the Indiana concentration account with respect to Pennsylvania Subsidiary exceeded mere solicitation of sales as said term is defined by 15 USC §§ 381-384 (1999) (P.L. 86-272). The executive officers were employees of taxpayer, not Pennsylvania Subsidiary. The services that said officers provided for Pennsylvania Subsidiary were services that parent corporations ordinarily provide for subsidiaries. Although employees of the Indiana based subsidiary were "loaned" to the Pennsylvania Subsidiary to supervise production of the product, the evidence of file before the Department does not establish that taxpayer's executive officers were involved in the day-to-day operations of Pennsylvania Subsidiary. Likewise, the fact that Pennsylvania Subsidiary's bank balance was swept nightly into a concentration account located at a bank in Indiana does not place Pennsylvania Subsidiary into a category of unprotected activity reaching beyond the mere solicitation of sales.

OHIO SUBSIDIARY

The Ohio Subsidiary was an Ohio corporation with manufacturing facilities and offices located in Ohio. Like the Pennsylvania Subsidiary, most of the executive decisions for the Ohio Subsidiary were made by the executive officers of the two subsidiaries who maintained offices in Indiana. As was previously stated, the individuals that make up the executive officers for the subsidiaries were located in Indiana.

Approximately forty-five percent (45%) of Ohio Subsidiary's total sales were to Indiana customers, which included an Indiana based subsidiary that was a member of taxpayer's affiliated group. Acceptance of orders from Indiana customers took place both in Indiana and Ohio. An Ohio Subsidiary salesman calling upon an Indiana customer had the authority to accept an order "on the spot". Once or twice per month, Ohio Subsidiary sent an employee (*i.e.*, a production manager or quality control manager) into Indiana to perform quality checks on product sold to Indiana customers. Employees of Ohio Subsidiary traveled to Indiana on a regular basis to answer customer complaints, provide technical assistance to the Indiana customers, and pick up or replace damaged or returned product.

Here, unlike the Pennsylvania Subsidiary, Ohio Subsidiary's activities in Indiana rose above mere solicitation when it offered technical assistance and remedied customer complaints regarding previously purchased products. A corporation's salesman does more than solicit orders in a state when he services complaints and gives technical assistance. *See Miles Laboratories*, 274 Ore. at 400, 546 P2d at 1083.

FINDING

Taxpayer's protest is partially sustained. The Department finds that whereas the Pennsylvania Subsidiary's activities failed to rise above mere solicitation as defined under P.L. 86-272, the activities of the Ohio Subsidiary did rise above mere solicitation. We further find that the Ohio Subsidiary did business in Indiana under 45 IAC 3.1-1-38(4). Since forty-five percent (45%) of Ohio Subsidiary's sales were attributable to Indiana, said subsidiary had income derived from Indiana sources under IC 6-3-2-2. As such, taxpayer should have been allowed to include the Ohio Subsidiary in its consolidated adjusted gross income tax filing, but not the Pennsylvania Subsidiary.

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